To implement pass-throughs, Corning and Scientific-Atlanta suggest that a cable system's per channel rate be adjusted to recover capital investment in advanced technology. The cable operator would thus be allowed to calculate its capital costs of system improvements, much like Schedules A and C call for currently as to operator's equipment costs.[42] The cable operator could be required to apply straight-line depreciation over the life of the plant, with allowances for plant under construction, debt service, and a reasonable rate of return on the capital investment. When seeking to raise rates on this basis, the cable operator would be obligated to present its underlying calculations and rationale to the reviewing body upon request.

A decision permitting cable operators to recover capital costs in this manner would serve three critical interests. First, it would sustain cable's means for investing in the technology required to deliver better services to subscribers. Second, it would thereby advance fundamental goals of federal communications policy. Finally, it would spare both cable operators and an already overburdened FCC from becoming enmeshed in unnecessary cost-of-service proceedings.

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[42] Report and Order app. A and C.

CONCLUSION

For the foregoing reasons, Corning and Scientific-Atlanta urge the Commission on to reconsider its treatment of capital investment in system improvements and to allow such costs external treatment under its price cap mechanism.

Respectfully submitted,

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Appendix

ESTIMATED IMPACT

OF

RATE RE-REGULATION

ON

CABLE TELEVISION CASH FLOWS

AND

CAPITAL EXPENDITURES

JUNE 1993

Deloitte & Touche

**ESTIMATED IMPACT OF RATE RE-REGULATION
ON CABLE TELEVISION CASH FLOWS AND
CAPITAL EXPENDITURES**

I. BACKGROUND OF THE ANALYSIS

The Cable Competition and Consumer Protection Act of 1992 serves as the foundation for the imposition of renewed regulatory oversight of the cable television industry by the Federal Communications Commission (FCC). Although rate re-regulation is only one element of the new regulatory framework, it has garnered a high level of interest in numerous public forums, with projections that the revenue streams of cable operators could be reduced by as much as $1.0 to $1.5 billion dollars annually. Furthermore, the FCC has estimated that as much as 75% of all CATV systems will be required to reduce their rates by as much as 10%, unless a cable operator is already charging rates that are at the "competitive benchmark" level calculated by the FCC or if the cable operator can justify higher rates based on costs of service provision.

Following the enactment of the 1992 Cable Act, the FCC entered a six month study and comment period, the result of which was a price cap regulatory model for the industry based upon "benchmark rates of cable systems subject to effective competition." The new FCC regulations are expected to

II. DESCRIPTION OF THE ANALYSIS

As described above, the overall objective of the analysis is to evaluate, for a representative sample of cable operators, the impact that the imposition of the rate re-regulation rules would have had on the cash flow generation and ability to support capital expenditures if these rules had been in place over the last several years (1990 to 1992). This analysis was constructed with actual financial data from several representative cable companies, which were aggregated to provide more of a "composite" view of the cash flow and capital expenditure impacts. The sections below outline the key elements of the analysis.

Company Selection Criteria and Industry Representation

The analysis is based upon the actual financial data of three cable operators for which public information is available. As shown below, data from the three companies was aggregated so as not to attribute cash flow and/or investment effects to particular companies. Criteria utilized to select the sample of three companies include company size, business concentration in the cable television industry, and company financial position as follows:

- The sample of three cable television companies was selected according to number of subscribers and revenue levels. In total, over six million basic subscribers are represented directly by the companies within the sample included in this analysis. Companies with similar subscriber bases to those within the sample represent over two-thirds of the basic subscribers of the top 100 cable system operators in the United States. Individual company size within the sample ranged from one to three million subscribers.

- Companies were selected for which the primary business was the ownership and operation of cable television systems. This selection criteria was established to isolate the impact of re-regulation on cash flow and capital investment on cable operators specifically, as opposed to entities for which cable television was only a part of a more diversified set of business activities.

- Companies of differing financial position were selected utilizing the measures of cash flow debt service coverage and debt leverage as measured by debt balances relative to cash flow been achieved under the regulated environment, holding all other factors constant. After evaluating the "pre-regulation" and "post-regulation" cash flow available for capital expenditures for each company individually, the individual financial results were consolidated to show the impact on an aggregate basis.

Assumptions Underlying the Analysis

The analysis is intended to be illustrative of the likely cash flow and capital investment impacts upon a composite of "typical" cable operators over a three year period (1990 to 1992). Several simplifying assumptions were utilized within the analysis which are described below:

- The analysis assumes that the rate regulation rules of the 1992 Cable Act were put in place at the beginning of fiscal year 1990, and is illustrative of the likely cash flow and capital expenditure impact of those rules over the period 1990 through 1992.

- The analysis assumes that basic service rated would be reduced by 10%, consistent with the estimates included in the FCC's order regarding cable rate regulation

- Pre-regulation operating relationships such as cash flow, operating margins, depreciation rates, etc. are a function of the actual financial results of the three companies included in our aggregated industry "composite"

- Revenue sources and distribution are consistent with general cable television industry averages as follows:

Revenue Class	1990	1991	1992
Basic/CPS	60%	62%	62%
Premium/Pay Services	30	28	27
Ancillary Services	8	8	9
Advertising	2	2	2
Total	100%	100%	100%

- Rate increases on basic/expanded basic services enacted since September 30, 1992 were assumed to be 5%.

- The September 30, 1992 rates for basic/CPS were reduced by 10% to reflect the FCC's estimated impacts of rate re-regulation on the prices of these services. The resulting rate was rolled forward by 1.5% to capture the estimated impact of inflation since September 30, 1992; the inflation adjustment is allowed under the FCC rules on rate re-regulation

- For the purposes of this analysis, it has been assumed that once rates had been adjusted to reflect the impacts of the cable rate regulation rules in the first year of our analysis, the FCC's price cap mechanism would be instituted for basic services. In this analysis, it has been assumed that the price index that would be applicable to basic tier services would increase basic tier revenues by 3% per year in 1991 and 1992. All other revenue streams have been held constant.

- Ancillary service revenues associated with installation and equipment have been assumed to be reduced by 33% (in 1990) in accordance with unbundling of equipment rentals and adoption of fees based on cost of providing equipment and installation services. In succeeding years, ancillary service revenued are assumed to grow at 3% per year.

- The analysis excludes any consideration of the potential impacts of cost of service filings on rate changes to various cable television system operators

- All other factors reflect actual results for the cable companies represented in our aggregate for the period 1990 to 1992.

III. IMPLICATIONS OF THE ANALYSIS

As stated above, one of the intended results of the 1992 Cable Act was to reduce rates to the cable consumer under the assumption the required rate reductions should not hinder the ability of the cable television industry to continue to provide quality services to consumers. Furthermore, the anticipated

- Interest payments are fixed financial obligations that must be met before funding for capital expenditures is typically considered. The effect of imposing the re-regulation rules upon the composite cable company included in this analysis would have rendered the aggregate cable company unable to meet interest payments during 1990 and substantially reduced their ability to meet debt obligations in fiscal years 1991 and 1992 (with very little coverage above actual interest payment levels). Interest coverage was adequate to meet debt obligations under the pre-regulation scenario in all three years included in the analysis 1990 to 1992.

- As noted in the above discussion, cash flow available for capital expenditures, while positive under the pre-regulation scenario, would have been negative in 1990, marginal in 1991 and positive during 1992 if the estimated rate re-regulation impacts had been in effect during 1990 to 1992. Under the pre-regulated environment, composite cable company generated over $542 million dollars in funds available for capital expenditures during the three year period under review (1990 to 1992), <u>while the imposition of the estimated impacts of cable re-regulation rules would have resulted in the generation of negative $10 million dollars in funds available for network upgrades and expansion over the same three year time frame (1990 to 1992)</u>. Thus, the cumulative net cash flow reduction as a result of re-regulation would have been $552 million (see Exhibit 2).

Furthermore, the above results ignore the effects of scheduled debt principal reductions. The

The post-regulation scenario illustrates the impact that would have occurred if the cable re-regulation rules had been in effect during 1990 to 1992. The composite company included in this analysis would not have met the interest coverage requirements in 1990; i.e., the composite company would have achieved an interest coverage ratio of less than 1.0X (See Exhibit 3.) Ignoring other potential forms of financing the composite company would have been in default of its interest payments during 1990 and would have improved its coverage to only 1.2X in 1992. Furthermore, debt/cash flow ratios range from 12X to 9X; well in excess of typically required ratios (see Exhibit 4). The importance of these results is that our composite cable company would have found it extremely difficult and highly unlikely to be able to have financed capital improvement projects through additional debt leverage during 1990 to 1992. The results of this analysis highlight that cable companies would likely have required various concessions from their creditors during this time frame.

While the equity markets are also a potential source of additional financing, cable companies have not traditionally relied heavily upon equity financing because of the marketplace "cost" of equity as compared to debt financing. Because of the high leverage position of the composite company, any equity financing that could be secured would likely be required to be used to reduce leverage rather than support additional capital expenditures. Given the limited use of equity financing under the pre-regulation scenarios, the illustrated impacts of the rate re-regulation on cash flow and financial leverage would likely have reduced the attractiveness of the aggregate cable company to potential equity investors during this same timeframe.

Furthermore, the composite company would not have been able to reduce other costs sufficiently to maintain the historical level of capital spending. A significant proportion of the composite cable company's costs are "fixed" in nature and tied to the provision of ongoing service delivery. For example, selling general and administrative expenses, which might be considered somewhat discretionary in nature in total only represent about one-fourth of operating costs for the composite company.

IV. SUMMARY AND CONCLUSIONS

The purpose of this analysis has been to assess what the effect of the FCC's estimates of rate rollbacks would have been on the ability of a sample of cable television companies to support capital expenditures if rate re-regulation had been in effect during the last three years. The results of this analysis demonstrate that the cable television industry would have experienced a significant reduction in cash flow from the rate re-regulation, which would have impaired significantly the ability of the cable companies in our composite to support capital expenditures.

The cumulative estimated cash flow reduction (available for capital expenditures) which would have been experienced over the three year time frame (1990 to 1992) is $552 million. This represents 60% of the total capital expenditures by the companies included in the sample of cable companies included in this analysis over the same time frame. Given the interest coverage requirements, cash from debt service coverage and financial leverage impacts of the imposition of the cable re-regulation rules on the cable television revenues and cash flow of the sample companies used in this analysis, it would have been extremely difficult and highly unlikely that these cable companies could have maintained the historical level of capital expenditures through additional financings.

Due to the above, further impairment of cash flows over the period would potentially have come from the higher cost of capital (interest charges) over the period. Also, a potential acceleration of debt maturity would likely have occurred, further impairing "free" cash flow available for capital expenditures.

Based on the results of this analysis, capital expenditures for plant upgrades, expansion and the potential introduction of new capabilities would have been reduced significantly to offset the financial

Exhibit 1

Estimated Impacts of

Exhibit 2

Estimated Impacts of Rate Reregulation on Cash Flow

(Cumulative)

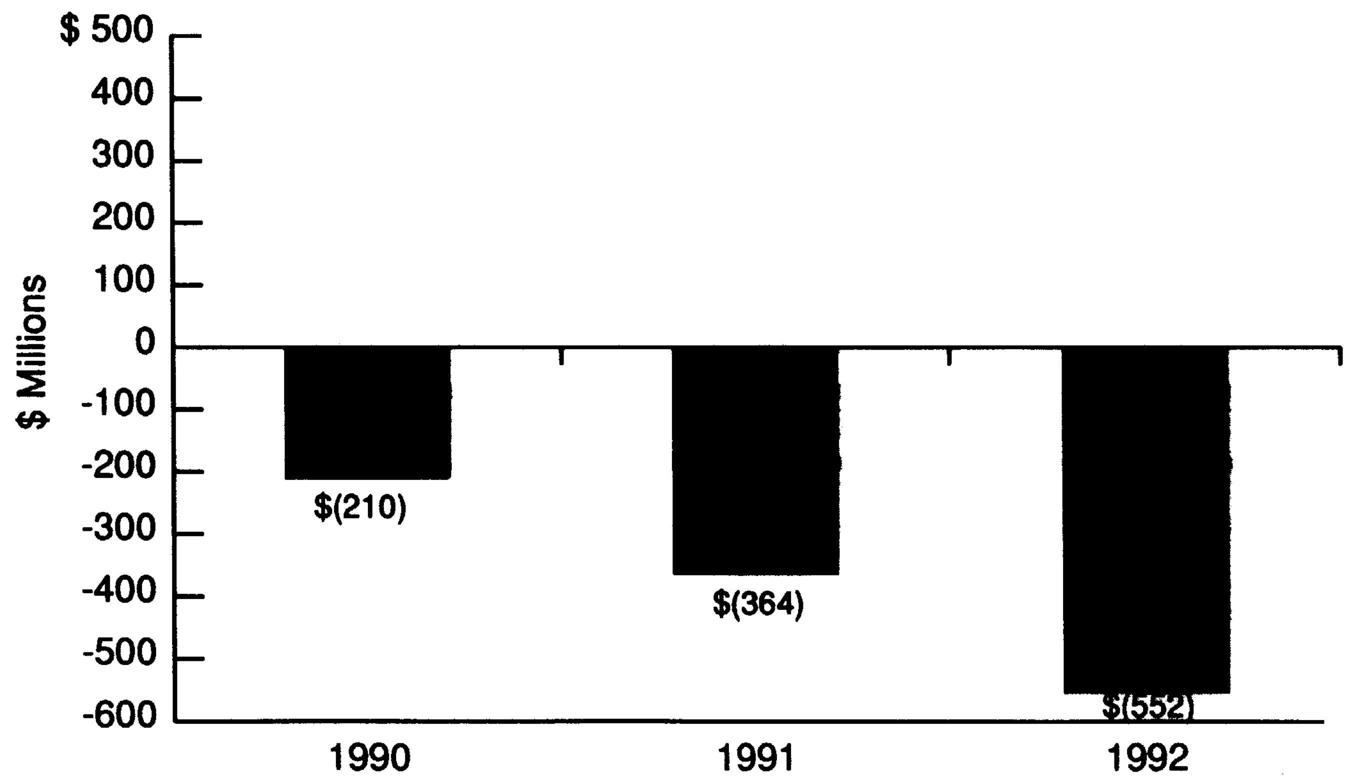

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Exhibit 3

Estimated Impacts of Rate Reregulation on Interest Coverage

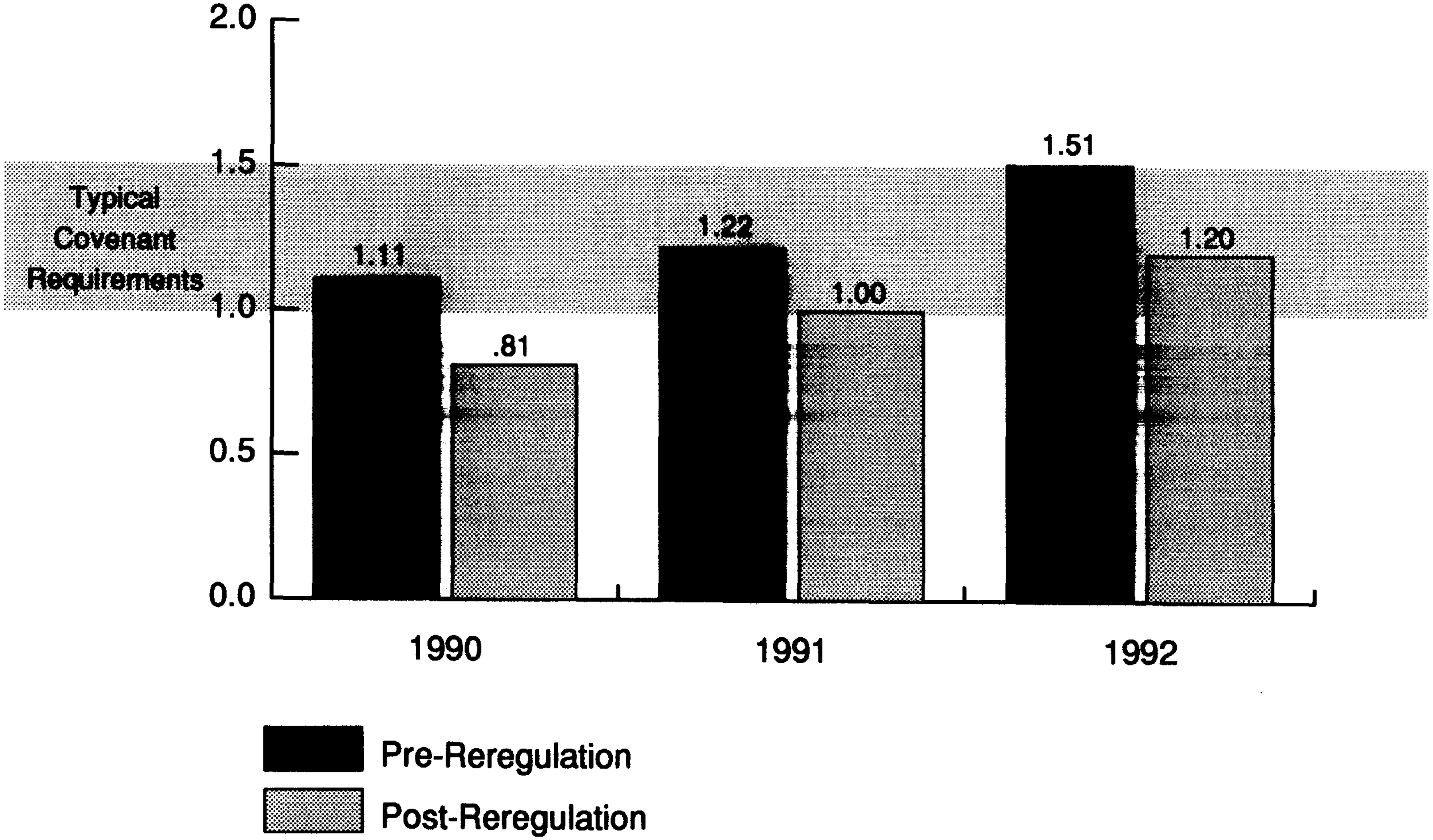

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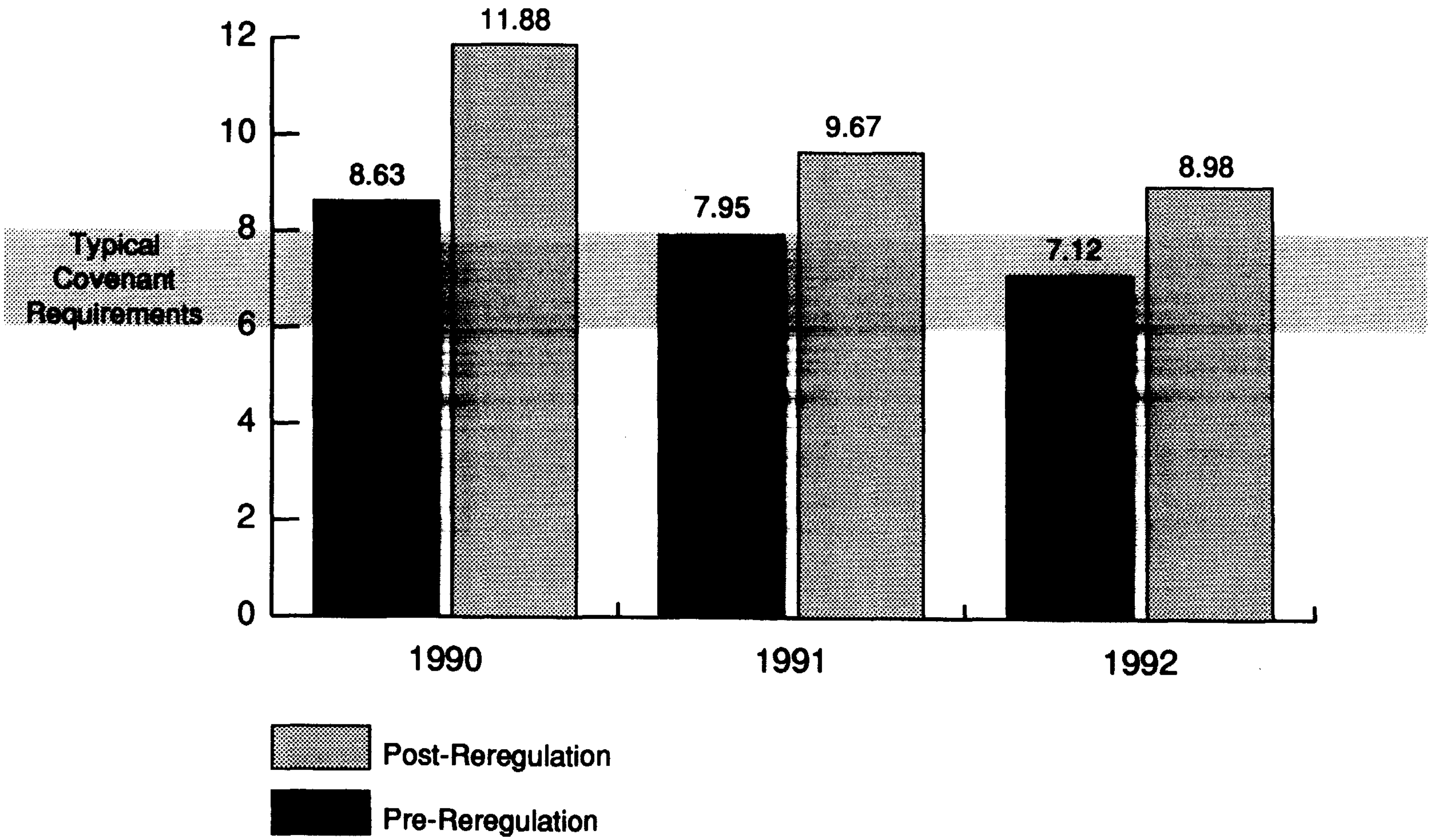
Exhibit 4

Estimated Impacts of Rate Reregulation on Debt/Cash Flow Ratio



Deloitte & Touche

<u>CERTIFICATE OF SERVICE</u>

I, Gladys Colon-Flowers, hereby certify that on this 21st day of June, 1993, I caused the original and 11 copies of the foregoing "Petition for Reconsideration" to be hand-delivered to:

Donna R. Searcy
Secretary
Federal Communications Commission
1919 M Street, N.W.
Washington, DC 20554

Gladys Colon-Flowers

Gladys Colon-Flowers